DESCRIPTION OF PROPOSAL RELATING TO COMPUTATION OF NET INCOME FOR COOPERATIVES

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

of the

COMMITTEE ON FINANCE

Prepared by the Staff

of the

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of a proposal by Senator Mattingly relating to the computation of net income for cooperatives. The proposal is scheduled for a public hearing on July 15, 1985, before the Senate Finance Subcommittee on Taxation and Debt Management.

The document provides a description of present law Code provisions relating to the Federal income tax treatment of cooperatives (including farmers' tax-exempt cooperatives) and of the proposal by Senator Mattingly.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Proposal Relating to Computation of Net Income for Cooperatives (JCX-8-85), July 12, 1985.

DESCRIPTION OF PROPOSAL RELATING TO COMPUTATION OF NET INCOME FOR COOPERATIVES -- SENATOR MATTINGLY

A. Present Law

In general

Cooperatives, including tax-exempt farmers' cooperatives, and their members are subject to special tax rules under subchapter T of the Code (sec. 1381 et seq.). In general, these provisions operate to treat the cooperative more like a conduit than a separate taxable business enterprise. The primary reason for doing so is to avoid penalizing (by imposing a corporate tax) a group of individuals or business organizations who collectivize their marketing or purchasing efforts in order to take advantage of economies of scale.

Definition of cooperatives

In general, the subchapter T rules apply to tax-exempt farmers' cooperatives described in section 521(b) or any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities).

A tax-exempt farmers' cooperative is specifically defined in section 521(b) as a farmers', fruit growers', or like association organized and operated on a cooperative basis for the purpose of marketing the products of its members or others, or for the purpose of purchasing supplies and equipment for members and other persons. In the case of a tax-exempt farmers' cooperative that markets products, the proceeds of sale by the cooperative less expenses of sale are turned over to the members or other producers on the basis of the quantity or value of the products furnished; in the case of a tax-exempt farmers' cooperative that purchases supplies and equipment, the purchased goods are to be made available at the cooperative's cost plus actual expenses.

Income tax treatment of cooperatives

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception--the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate

may be in a number of different forms.

In general, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. However, a tax-exempt farmers' cooperative generally may deduct patronage dividends to the full extent of its net income and may also deduct, to a limited extent, dividends on common stock. The availability of these deductions for the cooperative has the effect of allowing the cooperative to be treated like a conduit--in the case of tax-exempt farmers' cooperatives, with respect to all profits, and in the case of other cooperatives, with respect to profits derived from transactions with members.

Members of cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

B. Description of the "Netting" Issue

Frequently, a cooperative's business consists of making purchases or marketing goods in several product lines, several geographic areas, or both. Some cooperatives both make purchases and market goods. A typical practice for a cooperative that has such diverse activities is to calculate its net income on a cooperative-wide basis, netting gains from profitable products or geographic areas with losses from unprofitable ones. The cooperative pays patronage dividends based on the net income so computed. Assuming that the entire net income is distributed and the entire amount of the dividends is otherwise deductible, the cooperative takes the position that it has no tax liability.

The Internal Revenue Service has taken the position that the rules for taxing cooperatives do not allow a cooperative to net gains and losses from different operations in any manner it chooses. The IRS justifies this interpretation by reference to the requirement that a cooperative must allocate its profits and losses equitably among its patrons for purposes of paying patronage dividends. The IRS maintains, for example, that especially if not agreed to in advance by all patrons, allocation of the losses of the marketing

operations for product A against the gains from the marketing operations for product B (perhaps in a different region), may not be an equitable allocation, since it reduces the amount of patronage dividends that the patrons who supplied product B are entitled to. As a result, under this interpretation, the cooperative may not have fully distributed its profit attributable to the marketing of product B and is taxable on the undistributed amount of profit. Thus, under the IRS interpretation, unless netting were considered equitable under the circumstances, in order to eliminate its tax liability, the cooperative might have to pay dividends equal to the total profits of its profitable allocation units without reduction for the losses of its unprofitable allocation units.

The U.S. Tax Court decided in a 1980 case (Ford-Iroquois FS, 74 T.C. 1213 (1980)) that losses from a nonexempt cooperative's marketing operations could be carried forward to offset income from its supply operations, even where the losses that were carried forward were generated from transactions with patrons other than the patrons the gains from whose transactions were offset. The Tax Court has also held for the taxpayer in cases involving somewhat different circumstances where the IRS also argued that a cooperative had taxable income because it failed to make an equitable allocation among its patrons of its profits and losses (Lamesa Cooperative Gin, 78 T.C. 894 (1982) (a small amount of gains from a relatively insignificant supply operation could be offset against marketing operation losses); Associated Milk Producers, 68 T.C. 729 (1977) (losses from one year's operations could be carried forward to subsequent years)).

C. Explanation of Proposal

The proposal by Senator Mattingly relates to the provisions of subchapter T and the definition of tax-exempt farmers' cooperatives in section 521(b). The proposal would specify that in computing its net income, a cooperative may offset income from one or more of its allocation units (whether functional, divisional, departmental, geographic, or other) with losses from other allocation units. The proposal also would specify that a tax-exempt farmers' cooperative does not lose its exempt status merely because it offsets losses incurred in either its purchasing or marketing operations against earnings in either of such operations for purposes of computing its net earnings available for distribution to its patrons.

D. Other Congressional Action

The supplemental appropriations bill for fiscal year 1985, as reported by the Senate Committee on Appropriations

(H.R. 2577; S. Rep. No. 99-82), included an amendment by Senator Mattingly to prohibit the IRS from disallowing cooperatives subject to section 521 or subchapter T of the Code from netting earnings and losses among any of their purchasing and allocation units.

This provision was replaced by a Senate floor sense-of-the-Senate amendment to H.R. 2577 (by Senators Packwood and Mattingly) to have the Treasury Department study the question of whether cooperatives subject to section 521 or subchapter T of the Code may net earnings and losses among any of their purchasing and marketing allocation units in determining the amount of patronage dividends to be issued and their taxable income after the deduction for patronage dividends (see 131 Cong. Rec. S 8554-56 (daily ed. June 20, 1985)).